

Tax Terrorism: Nasty Truths about Investor Control Theory and the Accommodation of Social Security Privatization

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I. INTRODUCTION

While American taxpayers spend the vast majority of their tax lives shouldering the monetary burden of the prevailing progressive tax scheme, Congress will, periodically, lighten the load and extend the warm hand of legislative grace.¹ New deductions,² creative tax credits,³ and outright reductions in income tax rates⁴ are not uncommon, and in fact, political motivations have long fueled an aggressive interest in the modification of federal tax rules to curry favor with large segments of the population.⁵ The protection of retirement savings from

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1. See, e.g., *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

2. See generally Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, 17 Stat. 2469 § 1201 (codified in scattered sections of 26 U.S.C.) (indicating that for tax years beginning after December 31, 2003, an individual may be able, in effect, to secure a deduction for, *inter alia*, the cost of a weight loss or tobacco cessation program via the new § 223 of the Internal Revenue Code of 1986, as amended). See also I.R.S. Notice 2004-23 (April 12, 2004).

3. See, e.g., I.R.C. § 24 (2004) (providing for the child tax credit); I.R.C. § 32 (2004) (providing for the earned income credit).

4. See, e.g., I.R.C. § 1(i) (2004) (providing for tax rate reductions) (enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, § 101(a), Pub. L. No. 107-16).

5. See Greg Hitt & John D. McKinnon, *Bush Plays Down a Proposal to Slash the Taxes on Savings*, WALL ST. J., Feb. 2, 2004, at A4 (implying that George W. Bush emphasized

the burden of immediate taxation is a special congressional favorite.⁶ In addition to easing the tax burden on those disciplined enough to make financial provision for their retirement years, shielding money earmarked for use in old age makes eminently good sense and is profoundly appealing from a political perspective. One unfortunate side effect of Congress's occasional, tax-sheltering largesse, however, is the enhanced potential for taxpayer abuse. And for creative tax planners, retirement vehicles—like life insurance contracts and annuities—have been ripe with potential for quite some time.

Historically, life insurance contracts and annuities have served useful societal purposes. In the event of the untimely death of the principal breadwinner, the receipt of tax-free death benefits allows a surviving spouse to cover final expenses, care for minor children, and maintain the lifestyle to which they have become accustomed.⁷ Similarly, by providing a steady stream of income, deferred annuities allow seniors to enjoy active retirement years without the irritant of financial distress.⁸

Several years ago, despite contrary, state-level regulatory directives, insurance companies began to introduce various investor-friendly features to traditional life insurance and annuity products in an effort to attract investment dollars.⁹ To some limited extent, the introduction of variable life insurance contracts¹⁰ and variable annuities¹¹ gave investors the freedom to direct the investment of premium dollars¹² that under ordinary circumstances, are paid in over time and allocated internally to special accounts.¹³ By law, such accounts are segregated (for accounting and other purposes) from the insurance company's

his plan to extend existing tax cuts to appeal to the electorate during an election year).

6. See Tom Herman, *Tax Report: More Tax Breaks May Be on the Way*, WALL ST. J., June 12, 2003, at D2.

7. See Wayne M. Gazur, *Death and Taxes: The Taxation of Accelerated Death Benefits for the Terminally Ill*, 11 VA. TAX REV. 263, 317 (1991).

8. See Tommy F. Thompson, *Nonqualified Deferred Variable Annuities: A Product in Search of a Coherent Theory*, 79 N.D. L. REV. 439 (2003).

9. See S. REP. NO. 97-494(I), at 350 (1982), as reprinted in 1982 U.S.C.C.A.N. 781, 1095.

10. Under a variable life insurance contract, the death benefit (or coverage period) varies, depending on the investment return and market value of assets associated with the contract. See I.R.C. § 817(d)(3)(B) (2004).

11. Under a variable annuity contract, the amounts to be received by the contract holder generally vary according to the investment return and market value of assets associated with the contract. See I.R.C. § 817(d)(3)(A). Some annuity contract returns vary according to the company-wide investment experience of the issuing company. See *id.* § 817(g)(2)(B).

12. See, e.g., Rev. Rul. 82-54, 1982-1 C.B. 11.

13. See I.R.C. § 817(c).

general business accounts and are thus referred to as “segregated asset accounts” or “separate accounts.”¹⁴ While variable contract holders could participate in the investment of their premiums, these policyholders also enjoyed the same tax benefits historically associated with traditional life insurance and annuity contracts. These products continue to enjoy a tax-favored status. Thus, to the extent premium dollars paid in earn interest (or to the extent assets purchased with premium dollars appreciate in value), the investors suffer no immediate tax consequences, despite the enhanced overall “cash value” of their contracts.¹⁵ However, prior taxpayer attempts to abuse the “tax-free build-up” features, characteristic of life insurance contracts and annuities (especially via their “variable” incarnations), prompted Congress to respond. In particular, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”),¹⁶ which contained a number of temporary and permanent provisions. Two years later, Congress enacted the Deficit Reduction Act of 1984 (“DEFRA”),¹⁷ which brought about a number of changes in the taxation of insurance companies and their financial products.

Congress, of course, was not the only entity to respond to perceived taxpayer abuses. Before the enactment of TEFRA and DEFRA, through a series of Revenue Rulings¹⁸ issued in the early 1980s, the Internal Revenue Service (the “IRS” or the “Service”), introduced the so-called “investor control” doctrine. Ostensibly relying on overarching tax principles set forth in the common law, the Service asserted that taxpayers who, in substance, directed the investment of separate account assets underlying a contract (even if such assets were held by insurance companies on behalf of policyholders) would be treated as the owners of those assets for tax purposes.¹⁹ As a result, taxpayers would be forced to pay taxes currently on any investment earnings with respect to those

14. *See id.* § 817(b)-(c).

15. Such enhanced value is also referred to as “cash surrender value,” reflecting the fact that a contract holder is basically entitled to receive the fair market value of the contract by surrendering it to the company prior to the contract’s maturity date or, in the case of a life insurance contract, prior to the death of the insured. *See* I.R.C. § 7702(f)(2) (2004).

16. Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of 26 and 42 U.S.C.).

17. Pub. L. No. 98-369, 98 Stat. 494 (codified in scattered sections of 26 U.S.C.).

18. Revenue Rulings set forth the Service’s position with respect to a particular issue. While akin to positions stated on brief, Revenue Rulings do not constitute primary legal authority (law) and have neither the force nor the effect of Treasury Regulations. *See* 1 MERTENS LAW OF FEDERAL INCOME TAXATION § 1:7 (2005).

19. *See generally* Rev. Rul. 81-225, 1981-2 C.B. 12.

assets and thereby lose the ability to enjoy the tax-free build-up in the cash value of the associated life insurance or annuity contract.²⁰

While Congress, the Treasury Department, and the IRS have responded to taxpayer attempts to abuse the tax-favored status of life insurance and annuity contracts, the end result is only partially satisfactory from a tax theory perspective. Under the old, pre-TEFRA statutory regime, contract holders could effect a partial surrender of their contracts and thereby access contract earnings without paying the appropriate taxes, a result deemed untenable by both Congress and the IRS. This Article notes that although Congress fixed the basic problem and implemented clear deterrents by enacting TEFRA, the Service's investor control doctrine survives. Arguably, the doctrine now presents a host of administrability issues and may ultimately serve to exert a chilling effect on legitimate investment activity. Furthermore, the doctrine lacks firm theoretical footing. By requiring immediate taxation, the Service focuses more on the mere exercise of investor discretion rather than on that which traditionally heralds imminent and just taxation under well-established tax principles, namely "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."²¹ Congress's response to the basic problem (enacting specific Internal Revenue Code ("Code") provisions in TEFRA) has the added benefit of comports with this long-standing tax principle.

The privatization of Social Security²² could have promised profound challenges to the investor control doctrine (given the level of investor discretion anticipated). A recent IRS pronouncement, Revenue Ruling 2003-91,²³ handily eliminates the apparently imminent conflict between longstanding, IRS-asserted doctrine and the demands of the political arena. One could argue that the pronouncement reflects little more than doctrinal evolution, but such evolution is a giant leap away from the twenty-two-year-old notion that investor discretion should be minimal and appears to be a doctrinal accommodation of potential Social Security privatization. This Article argues that the investor control doctrine should be dismissed. I further propose that investor discretion should

20. *See id.*

21. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (disregarding the fact that certain damages received by a litigant were "punitive" and holding that such damages constituted gross income).

22. *See generally* Report of the President's Commission to Strengthen Social Security, STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS (2001).

23. Rev. Rul. 2003-91, 2003-2 C.B. 347.

be allowed with respect to the investment of contract assets, subject to (1) investment professional guidance or risk assessment, (2) age-sensitive adjustments with respect to the percentage of contract assets subject to investor discretion, and (3) limits with respect to the aggregate amount a taxpayer may invest in variable life insurance or variable annuity contracts.

Part II of this Article provides background information, chronicling the pre-TEFRA investor abuse environment, the Service's initial doctrinal response, Congress's legislative reaction (under TEFRA and DEFRA), and post-DEFRA developments. Part III of this Article presents a critique of the modern investor control doctrine in light of its theoretical footing and presents arguments related to the doctrinal accommodation of Social Security privatization. The focus shifts forward in Part IV where I present the variable contract model. In Part V, I present an argument summary and my general conclusions.

II. BACKGROUND

Public policy has long supported the various benefits associated with life insurance contracts and similar financial instruments issued by insurance companies:

The Treasury Department has in the past recognized and continues to recognize the social benefits of encouraging insurance protection. In the event of the death of a working spouse, life insurance proceeds can be a source of support for the surviving spouse and minor children, and can enable the survivors to maintain their standard of living. In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby relieving the government of an obligation it otherwise would have to assume.²⁴

The same can be said with respect to the purchase of annuity contracts and the prevention of financial distress and governmental dependency in the retirement years.²⁵ With the innovative assistance of those in the life insurance industry, taxpayers have, over the years, attempted to abuse these products by (1) investing large sums of money in them; (2) enjoying the tax-free build up in policy cash values; and (3) attempting

24. Gazur, *supra* note 7, at 317 (quoting a Treasury Department official).

25. See S. REP. NO. 97-494(I), at 350 (1982), as reprinted in 1982 U.S.C.A.N. 781, 1085 (indicating that "[t]raditionally, annuity contracts have been viewed as safe, conservative, but low-yielding investments purchased by individuals who wish both to provide for income during their retirement and to insure against the possibility of outliving their assets").

to access policy earnings prematurely (with no tax result) either by taking loans out against the policy, using the policy as collateral, or effecting a partial surrender of the policy.²⁶ This activity was particularly prevalent during the late 1970s, and the Service responded to these developments by issuing a series of Revenue Rulings.²⁷ In addition to setting forth the Service's view of the federal income tax ramifications of such transactions, the rulings also served to spark the evolution of the so-called "investor control" doctrine.²⁸ Under that doctrine, investors purchasing variable contracts, yet effectively maintaining a certain degree of control over the investment of their premium dollars, are deemed to own the purchased assets.²⁹ In the Service's parlance, such policyholders maintain "sufficient incidents of ownership" over the assets supporting their contracts.³⁰ Accordingly, any earnings attributable to such assets are taxed currently to the policyholder.³¹

A. *"Wraparound Annuities" and the Early Revenue Rulings*

Perhaps the earliest Revenue Ruling of note is Revenue Ruling 77-85³² (for schematic, see Figure 1). The facts of the ruling indicate that the taxpayer purchased an investment annuity from an insurance company while, at the same time, making a required deposit with a "Custodian" (i.e., a financial institution). This Custodian, in turn, made investments at the specific direction of the policyholder (e.g., purchases, sales, exchanges, and the investment (or reinvestment) of principal and interest). While the policyholder was allowed to make investments only from a list approved by the insurance company, such investments often included publicly traded stocks and federally insured bank deposit instruments. Further, the policyholder directed the voting of relevant shares. The policyholder could not receive funds directly from the Custodian, but was free to liquidate his investment by effecting a partial or complete surrender of the contract to the insurance company prior to the date on which annuity payments were to commence (i.e., the "annuity starting date"). The Service concluded that the policyholder

26. See *id.* (indicating that during the late 1970s and early 1980s, deferred annuities were marketed as tax shelters and used as short-term, tax-favored investments).

27. See, e.g., Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

28. See Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

29. See Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

30. Rev. Rul. 82-54, 1982-1 C.B. 11.

31. Rev. Rul. 77-85, 1977-1 C.B. 12 at 8.

32. Rev. Rul. 77-85, 1977-1 C.B. 12.

owned the assets of the custodial account because he possessed significant incidents of ownership over the assets in the account at all times. As a result, the policyholder was subject to current taxation on asset earnings received by the Custodian in the year of the Custodian's receipt. The Service, in reaching its conclusion with respect to the policyholder's possession of significant incidents of ownership, emphasized the following:

- The policyholder's power to direct the sale, purchase, or exchange of securities or other assets held in the custodial account (i.e., "investment control");³³
- The policyholder's power to vote custodial account securities (i.e., "voting control"); and
- The policyholder's ability to enjoy the benefits of any income produced by (or appreciation in value of) custodial account assets by surrendering the contract (partially or completely) and effectively withdrawing earnings (i.e., "surrender rights").³⁴

Shortly after the issuance of Revenue Ruling 77-85, the Service followed with Revenue Ruling 80-274³⁵ (for schematic, see Figure 2). The facts of that ruling indicate that the taxpayer purchased a single-premium retirement annuity from an insurance company that per the agreed-upon plan, purchased a certificate of deposit from a savings and loan association. While the policyholder had no relationship with the savings and loan association, he could assert his rights under the annuity contract and thereby access contract earnings by effecting a partial or complete surrender of his contract.³⁶

The Service concluded the following:

To the extent [the] policyholder . . . possesses substantial incidents of ownership in an account established by the insurance company at the direction of the policyholder, the policyholder may be considered the owner of the account for federal income tax purposes [The] policyholder's position is substantially identical to what the policyholder's position would have been [if] the investment [had] been directly maintained or established with the savings and loan association.³⁷

33. The Service also emphasized the policyholder's ability to enhance the value of his annuity contract by his discretionary investment efforts. This ability flows directly from "investment control."

34. See Rev. Rul. 77-85, 1977-1 C.B. 12.

35. See Rev. Rul. 80-274, 1980-2 C.B. 27.

36. See *id.*

37. Rev. Rul. 77-85, 1977-1 C.B. 12 at 5-6.

Read together, both Revenue Ruling 77-85 and Revenue Ruling 80-274 indicate that in the eyes of the Service, investors exercising control over the investment of their premium dollars (whether directly or by explicit understanding) will be deemed to be the owners of the purchased assets and required to pay taxes currently with respect to the gains or income realized for those assets.³⁸ Even then, the Service was not done. Determined to prevent the use of insurance companies as conduits with respect to any taxpayer seeking to employ an annuity contract as a short-term investment, the Service released Revenue Ruling 81-225,³⁹ and the investor control doctrine's evolution took a giant leap forward.

Rather than presenting a single fact scenario for analysis, Revenue Ruling 81-225 presents five situations, each with minor yet distinct factual variations. In most of the situations, an individual purchases a deferred variable annuity contract with the knowledge that the monies will be allocated to a separate variable account which will, in turn, invest in the shares of a specific mutual fund (the "XY Fund").⁴⁰ Those variations (with facts most pertinent for analysis) are as follows:

Situation 1 (for schematic, see Figure 3): XY Fund shares can be purchased by the general public, and a separate independent advisor, Z, manages the investments of the Fund.⁴¹

Situation 2 (for schematic, see Figure 4): XY Fund shares can be purchased by the general public, and the insurance company (or an affiliate of the insurance company) manages the investments of the Fund.⁴²

Situation 3 (for schematic, see Figure 5): The separate variable account is divided into sub-accounts, each of which invests in a separate identified mutual fund. The shares of each identified mutual fund can be purchased by members of the general public.⁴³

Situation 4 (for schematic, see Figure 6): Fund shares cannot be purchased by the general public, but they can be made available by the purchase of an annuity contract *or* by the opening of a special account with the insurance company (thereby forgoing the purchase of an annuity contract).⁴⁴

38. See Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27.

39. Rev. Rul. 81-225, 1981-2 C.B. 12.

40. See *id.*

41. Rev. Rul. 81-225, 1981-2 C.B. 12 at 2-3.

42. Rev. Rul. 81-225, 1981-2 C.B. 12 at 4-5.

43. Rev. Rul. 81-225, 1981-2 C.B. 12 at 5.

44. *Id.*

Situation 5 (for schematic, see Figure 7): Fund shares cannot be purchased by the general public and are available only by the purchase of an annuity contract.⁴⁵

The Service concludes that in Situations 1-4, “the policyholder has investment control over the mutual fund shares and possesses sufficient other incidents of ownership to be considered the owner of the mutual fund shares for federal income tax purposes.”⁴⁶ Given that mutual fund shares were available to the general public either directly or indirectly (as with the transfer accounts alluded to in Situation 4), the Service emphasized the following:

Although a mutual fund’s diversified portfolio of securities is controlled by the manager of the mutual fund and not by the policyholder, this does not distinguish these situations from Revenue Ruling 77-85 and Revenue Ruling 80-274 because the mutual fund [shares] themselves are securities the incidents of ownership of which may be attributed to the policyholder in these situations. Prior to the annuity starting date, [the insurance company] is, in such circumstances, little more than a conduit between the policyholders and their mutual fund shares.⁴⁷

The Service went on to conclude that investor control was not present in Situation 5, reasoning as follows:

[T]he shares of [the Fund] are not separate investment assets; [the Fund] is nothing more than the alter ego of [the insurance company]. The sole function of [the Fund] is to provide an investment vehicle to allow [the insurance company] to meet its obligations under its annuity contracts. This situation is equivalent for federal income tax purposes to the direct purchase by [the insurance company] of the underlying portfolio of assets of [the Fund]. [The insurance company] possesses sufficient incidents of ownership to be considered the owner of these underlying assets for federal income tax purposes.⁴⁸

The Service’s final pre-TEFRA pronouncement of significance in this arena took the form of Revenue Ruling 82-54⁴⁹ (for schematic, see Figure 8). Under that ruling, policyholders had the power to allocate premium dollars to individual mutual funds, each of which followed a distinct investment strategy (e.g., stock fund, bond fund, money market fund).⁵⁰ In addition to being able to make initial allocations, policy-

45. *Id.*

46. Rev. Rul. 81-225, 1981-2 C.B. 12 at 6-7.

47. Rev. Rul. 81-225, 1981-2 C.B. 12 at 7.

48. Rev. Rul. 81-225, 1981-2 C.B. 12 at 8.

49. Rev. Rul. 82-54, 1982-1 C.B. 11.

50. *See id.*

holders had the right to change their allocations prior to the contract's maturity date. Shares of the individual funds were not available to the general public, and the insurance company, as investment advisor, had the sole right to substitute the shares of one fund for shares of a similar fund. The Service, concluding that the mutual fund shares were, in fact, owned by the insurance company, noted the following:

Under Revenue Ruling 81-225, in order for the insurance company to be considered the owner of the mutual fund shares, control over individual investment decisions must not be in the hands of the policyholders. However, the ability to choose among broad, general investment strategies such as stocks, bonds, or money market instruments, either at the time of the initial purchase or subsequent thereto, does not constitute sufficient control over individual investment decisions so as to cause ownership of the private mutual fund shares to be attributable to the policyholders.⁵¹

Thus, to the extent that there were current earnings on policyholder contracts, the relevant policyholders were not required to pay taxes in the year such earnings were realized by the separate account.⁵²

Stated as a synthesized rule, investors will be deemed to own the assets underlying their life insurance or annuity contracts (and required to pay taxes on current earnings) to the extent such policyholders possess sufficient incidents of ownership with respect to such assets.⁵³ While the doctrine originally addressed those situations in which investors actually directed the investment of their premium dollars via a financial custodian,⁵⁴ the rule broadened (modestly) to include situations where the direction of investment was indirect, but agreed-upon and thus understood.⁵⁵ Revenue Ruling 81-225 nourished the doctrine aggressively. In the aftermath of its release, policyholders who could either invest in any publicly available mutual fund by purchasing an annuity contract or invest in a private, insurance company mutual fund without purchasing an annuity contract could be viewed, in effect, as using the insurance company as a tax-sheltering conduit and thus could be forced to pay taxes on current contract earnings.⁵⁶ Fortunately, policyholders were later given the freedom to direct the investment of premium dollars by allocating to broad, generalized investment

51. Rev. Rul. 82-54, 1982-1 C.B. 11 at 5.

52. *See id.*

53. Rev. Rul. 82-54, 1982-1 C.B. 11 at 4.

54. *See* Rev. Rul. 77-85, 1977-1 C.B. 12.

55. *See* Rev. Rul. 80-274, 1980-2 C.B. 27.

56. *See* Rev. Rul. 81-225, 1981-2 C.B. 12.

strategies (i.e., stocks, bonds, money market investments) without suffering adverse tax consequences.⁵⁷

B. Congress's Initial Response (TEFRA)

At the same time the Service took steps to curtail the use of insurance company contracts as short-term investments, Congress prepared legislative responses that at least initially, took the form of TEFRA. Lamenting the use of annuity contracts as short-term investments, the legislators noted the following:

In recent years, however, the life insurance industry has developed new products that provide an investment yield for the policyholder that is competitive with other commercial investments that do not enjoy the same tax treatment. By emphasizing the benefits of tax deferral [prior to the annuity starting date], the tax-favored treatment of partial surrenders, and options for lump sum settlements, deferred annuities have been actively marketed as tax shelters. Although the current tax rules [governing the taxation of annuity payments] were enacted when deferred annuities were used to provide long-term income security, variations on traditional products have been developed [such that some annuities may now be] comparable to short-term money market investments.

The [Senate Finance Committee] believes that the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal. However, the committee believes that their use for short-term investment and income tax deferral should be discouraged.⁵⁸

Several steps were taken. First, Congress changed the rules governing the taxation of “premature” distributions from certain life insurance and annuity contracts (i.e., distributions received before the annuity starting date). Under prior law, individuals could receive premature distributions from their contracts tax-free, so long as they received no more than their “investment in the contract” (i.e., which, typically, was the aggregate amount of premiums previously paid in); thereafter, distributions were regarded as “income on the contract” and subject to tax.⁵⁹ Under such a regime, policyholders could invest in a contract, enjoy the tax-free build-up in its cash value, and siphon off the earnings as a tax-free recovery of their investment in the contract by effecting a partial

57. See Rev. Rul. 82-54, 1982-1 C.B. 11.

58. S. REP. NO. 97-494(I), at 350 (1982), as reprinted in 1982 U.S.C.C.A.N. 781, 1085.

59. See S. REP. NO. 97-494(I), at 349 (1982), as reprinted in 1982 U.S.C.C.A.N. 781, 1084 (discussing the tax consequences of “premature” withdrawals prior to the amendment of the Code by TEFRA); I.R.C. § 72(e)(2)(b)(i), (ii) (2004).

surrender. In TEFRA, Congress changed the order of things by requiring that premature distributions be taxed first as income on the contract (to the extent the cash value of the contract exceeded the investment in the contract at the time) before allowing the tax-free recovery of the taxpayer's investment in the contract.⁶⁰ This new Code provision was referred to as the "interest first" or "income first" rule, and it applied to premature distributions (referred to in Code parlance as "amounts not received as an annuity").⁶¹

Second, Congress enacted provisions that under some circumstances, would result in the treatment of loans under certain contracts as premature distributions subject to the income first rule.⁶² Thus, direct policy loans, indirect policy loans, assignments of contract value, pledges of contract value, and agreements to assign or pledge value could result in taxation of the policyholder.⁶³ While specific exceptions to the general rules were included,⁶⁴ Congress's actions reflected a clear focus on the immediate taxation of those receiving funds from retirement vehicles prematurely.

Third, to drive the point home, Congress also required those taking premature distributions to pay a ten percent penalty on the amounts includible in gross income.⁶⁵ As with related rules, exceptions were incorporated,⁶⁶ but as a class, such exceptions consistently reflected the need to allow access to funds in a tax-friendly environment when the underlying vehicles had been used for legitimate, traditional purposes.

60. See S. REP. NO. 97-494(I), at 350-51 (1982), as reprinted in 1982 U.S.C.C.A.N. 781 1085-86.

61. Amounts not received as an annuity before the annuity starting date are allocated to "income on the contract" (included in gross income) and "investment in the contract" (not included in gross income). See I.R.C. § 72(e)(2)(B). To the extent the cash value of the contract exceeds the aggregate investment in the contract, amounts not received as an annuity before the annuity starting date are treated as income on the contract. See *id.* § 72(e)(3)(A). Other amounts are treated as investment in the contract. See *id.* § 72(e)(3)(B).

62. See *id.* § 72(e)(4).

63. See *id.* § 72(e)(4)(A).

64. Certain contracts were grandfathered (to the extent of investment in the contract existing at the time of TEFRA's enactment). See *id.* § 72(e)(5)(B). Congress also saw fit to apply the old rule to amounts received under certain life insurance contracts, see *id.* § 72(e)(5)(C), and to amounts received as full refunds, and on complete contract surrenders, contract redemptions, or at contract maturity. See *id.* § 72(e)(5)(E).

65. See *id.* § 72(q)(1).

66. See *id.* § 72(q)(2).

C. Congress's Subsequent Response (DEFRA)

While the pertinent TEFRA provisions directly addressed the treatment of policyholders attempting to tap contract earnings by taking premature distributions, key rules introduced by DEFRA addressed the character and general investment profile of insurance company separate accounts, the vehicles by which premiums are invested. Congress's apparent goal (given the concerns articulated in the legislative history with respect to the "public availability" of investment funds) was to ensure that a contract holder could not enjoy a tax-free build-up while occupying the same basic investment status as someone who (1) opted to open a traditional brokerage account and invested in the same publicly available fund as the one invested in by the insurance company's separate account, but (2) is forced to shoulder the burden of annual taxation on fund earnings.⁶⁷ The House Conference Report in pertinent part states:

In addition, the conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. The fact that a similar fund is available to the public will not cause the segregated asset fund to be treated as being publicly available.

In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, [adverse tax consequences may result with respect] to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets . . . [or in] one or a relatively small number of publicly available mutual funds This new diversification authority is not intended to allow the imposition of any requirement that the investment fund reflect a diverse range of investment goals (e.g., short-term/long-term, or fixed income/equity securities need not be mixed in a single fund).⁶⁸

Thus, DEFRA added to the Code section 817(h), which requires, among other things, that separate accounts underlying variable contracts be

67. See generally H.R. REP. NO. 98-861, at 1053-56 (1984) (Conf. Rep.), as reprinted in 1984 U.S.C.C.A.N 1445, 1741-44.

68. H.R. REP. NO. 98-861, at 1055 (1984), as reprinted in 1984 U.S.C.C.A.N 1445, 1743.

“adequately diversified.”⁶⁹ Further, Congress authorized the Treasury Department to promulgate detailed “adequate diversification” standards.⁷⁰ Together, the Code-based rules, the Treasury Regulations, and the legislative history lay out a reasonably clear landscape.

Separate account assets (i.e., premium dollars or purchased assets such as stocks, bonds, or mutual fund shares or both) supporting variable contracts are *not* to be invested in funds that are available to the general public. Thus, the only way an individual can invest in such funds (regardless of whether similar funds are publicly available)⁷¹ is by purchasing a variable contract from an insurance company.⁷² While members of the general public are free to purchase an annuity contract and subject themselves to various distribution rules⁷³ and potential penalties,⁷⁴ Congress sought to ensure that no individual could enjoy a tax-free build-up while occupying substantially the same position as an individual who opted to open a brokerage account and paid taxes currently on realized gains and asset earnings.⁷⁵ In mandating adequate diversification⁷⁶ (and making it abundantly clear that such efforts were not meant to encourage a wise mix of investments),⁷⁷ Congress clarified its overarching intent to ensure that a policyholder could not effectively invest in one or a relatively small number of investments by purchasing a variable contract and allocating premiums to a specific separate account *known* to be devoted to a *particular investment* or *known* to have an exceedingly *narrow investment profile*.⁷⁸ Current diversification rules essentially require that a separate account have a minimum of five investments and that such investments fall within the following prescribed percentage parameters (for schematic, see Figure 9):

- No one investment may constitute more than fifty-five percent of the value of the total assets of the account;⁷⁹

69. See I.R.C. § 817(h)(1) (2004).

70. See *id.*

71. See H.R. REP. NO. 98-861, at 1055 (1984), as reprinted in 1984 U.S.C.C.A.N 1445, 1743.

72. See Rev. Rul. 81-225, 1981-2 C.B. 12.

73. Cf. I.R.C. § 72(e).

74. Cf. *id.* § 72(q).

75. See generally H.R. REP. NO. 98-861, at 1053-56 (1984), as reprinted in 1984 U.S.C.C.A.N 1445, 1741-44.

76. See I.R.C. § 817(h).

77. See H.R. REP. NO. 98-861, at 1055 (1984), as reprinted in 1984 U.S.C.C.A.N 1445, 1743.

78. See *id.*

79. See Treas. Reg. § 1.817-5(b)(1)(i)(A) (2003).

- No two investments may constitute more than seventy percent of the value of the total assets of the account;⁸⁰
- No three investments may constitute more than eighty percent of the value of the total assets of the account;⁸¹ and
- No four investments may constitute more than ninety percent of the value of the total assets of the account.⁸²

Thus, by allocating premiums to adequately diversified separate accounts (which invest in funds that are not publicly available and may only be accessed by purchase of a contract) and avoiding the temptation of premature withdrawals, investors purchasing life insurance or annuity contracts will enjoy the tax-favored status that Congress intended.

III. CRITIQUE OF THE INVESTOR CONTROL DOCTRINE

A. *Theoretical Foundation*

An effective critique of the investor control doctrine begins with the Service's most recent pronouncement in the area, Revenue Ruling 2003-91⁸³ (for schematic, see Figure 10). The ruling is particularly relevant, not only because it presents the doctrine's modern, post-TEFRA, post-DEFRA form, but also because it sets forth, to some extent, the Service's common law, theoretical foundation in support of the doctrine.

The facts of the ruling provide that an individual, the "Holder," purchases a variable life insurance contract (or a variable annuity) from a life insurance company. Premiums paid in are allocated to the insurance company's separate account, which is divided into thirteen sub-accounts, each reflecting a different investment strategy.⁸⁴ Holders have the power to allocate premiums to currently available sub-accounts and may change that allocation at any time or move funds from one sub-account to another.⁸⁵ At the company's discretion, the separate account may be further subdivided such that up to twenty sub-accounts will be

80. See *id.* § 1.817-5(b)(1)(i)(B).

81. See *id.* § 1.817-5(b)(1)(i)(C).

82. See *id.* § 1.817-5(b)(1)(i)(D).

83. Rev. Rul. 2003-91, 2003-2 C.B. 347.

84. While the ruling indicates that "[t]welve [s]ub-accounts are currently available," the facts actually indicate that there are thirteen "currently available [s]ub-accounts." Rev. Rul. 2003-91, 2003-2 C.B. 347.

85. Allocation discretion reflects how premiums paid in are allocated initially to separate accounts. Reallocations or fund transfers reflect the movement of money from fund to fund after initial allocation (or, quite possibly, changes in the allocation of premiums arriving after the initial premium).

available for investor allocation of premiums. While the Service notes that the determination of asset ownership “depends on all of the relevant facts and circumstances,” the Service ultimately concludes that under the facts presented, “Holder does not possess sufficient incidents of ownership over the assets supporting either [the life insurance contract or the annuity] to be deemed the owner of the assets for federal income tax purposes.”⁸⁶ The Service emphasized the following facts:

- Holder may not select or direct a particular investment to be made by either the separate account or the sub-accounts;
- Holder may not sell, purchase, or exchange assets held in the separate account or the sub-accounts;
- Disregarding Holder allocations, reallocations, and inter-fund transfers, the insurance company (or investment advisor) makes all investment decisions in its sole and absolute discretion;
- The investment strategies of the sub-accounts are “sufficiently broad” to prevent Holder from making particular investment decisions through investment in a sub-account;
- Only the insurance company (or investment advisor) may add or substitute sub-accounts or investment strategies;
- There are no side agreements between Holder and the insurance company or between Holder and the investment advisor concerning specific investments or general investment objectives;
- Holder may not communicate directly or indirectly with investment advisors or insurance company investment officers concerning separate account or sub-account investments;
- The insurance company alone is responsible for the selection and replacement of any external investment advisor or internal investment officers; and
- Sub-accounts are not publicly available, and investment may be accomplished only by the purchase of a variable life or variable annuity contract.⁸⁷

Before reaching its final conclusion, the Service was careful to note that “[Holder’s] ability to allocate premiums and transfer funds among [s]ub-accounts alone does not indicate that Holder has control over either [s]eparate [a]ccount or [s]ub-account assets sufficient to be treated as the owner of those assets for federal income tax purposes.”⁸⁸

The Service points to statutes, cases, legislative materials, prior Revenue Rulings, and other materials to support its position.⁸⁹ After

86. Rev. Rul. 2003-91, 2003-2 C.B. 347.

87. *See id.*

88. *Id.*

89. *See id.*

noting that under the Code, gross income means “all income from whatever source derived,”⁹⁰ the Service proceeds to quote United States Supreme Court precedent and to reference related authority from the Eighth Circuit Court of Appeals:

A long standing doctrine of taxation provides that “taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.” The incidence of taxation attributable to ownership of property is not shifted if the transferor continues to retain significant control over the property transferred, without regard to whether such control is exercised through specific retention of legal title, the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency.⁹¹

Thereafter, the Service discusses its prior investor control Revenue Rulings and devotes substantial attention to *Christoffersen v. United States*⁹² before going on to discuss DEFRA (emphasizing Congress’s focus on “public availability” and its introduction of adequate diversification requirements) and the Treasury Department’s promulgation of adequate diversification standards (which, per explicit disclaimer, provided no guidance concerning the investor control doctrine).⁹³ Revenue Ruling 2003-91 purports to be a safe harbor, providing variable contract holders with the assurance that they may allocate their premiums broadly without negative tax consequence.⁹⁴ Replete with requirements, prohibitions, and gag orders, such a safe harbor can be exceedingly difficult to navigate. And with the combined net assets of U.S. variable annuities at \$1.0 trillion,⁹⁵ the investor control doctrine

90. *Id.*

91. *Id.*

92. 749 F.2d 513 (8th Cir. 1984). In *Christoffersen* the Eighth Circuit Court of Appeals held that taxpayers purchasing a variable annuity contract who (i) held the power to direct the investment of their premiums to publicly available mutual funds, (ii) could reallocate their investments at any time, and (iii) could withdraw funds from or surrender their contracts were to be considered the owners of the mutual fund shares associated with the variable contract. Accordingly, such taxpayers were to be taxed currently on contract earnings.

93. See 51 Fed. Reg. 32,664 (Sept. 15, 1986).

94. See Rev. Rul. 2003-91, 2003-2 C.B. 347.

95. See Deborah Tucker, National Association for Variable Annuities, *NAVA Reports Third Quarter Variable Annuity Industry Data* (December 1, 2004), http://www.navanet.org/frames/press_dex.htm (last visited March 11, 2005).

can, in fact, rapidly wreak havoc as a weapon of mass financial disruption.

The Service clarifies at the outset that asset ownership requires a facts-and-circumstance analysis.⁹⁶ But is that an arrow or olive branch? While such language could easily encourage taxpayers, it must be remembered that a facts-and-circumstances approach allows considerable discretion; accordingly, the Service can employ that standard as both sword and shield. The ruling itself presents so many “thou shalt nots” that the Service, on detecting activity it finds unpalatable, will have no difficulty challenging its propriety. Unlike prior rulings in which the Service focused primarily on a contract holder’s exercise of investment discretion and, in some instances, the public availability of investment options,⁹⁷ Revenue Ruling 2003-91 introduces gag orders, prohibiting both investment-related side agreements and investment-related communications between contract holders and the insurance company (or the relevant investment advisor).⁹⁸ Investors have known for quite some time that negative tax consequences will attend any attempt to control the investment of separate account assets. Revenue Ruling 2003-91, with its introduction of stern laissez faire mandates, attempts a severe curtailment of investment-related, policyholder-company communications. While the mere articulation of the mandate certainly threatens to chill what could be legitimate investment-related activities, the stark reality is that effective compliance remains difficult (but not impossible) to police. The Service cannot control who shares lunch with whom or what conversations take place at the country club or elsewhere, but taxpayers under constant examination or audit⁹⁹ face a clear and perpetual threat.¹⁰⁰

Revenue Ruling 2003-91 also manages, perhaps inadvertently, to introduce ambiguity in two respects. First, the ruling can be read to dictate that a company may have no more than twenty sub-accounts, a

96. See Rev. Rul. 2003-91, 2003-2 C.B. 347.

97. See, e.g., Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 77-85, 1977-1 C.B. 12.

98. Rev. Rul. 2003-91, 2003-2 C.B. 347.

99. Certain taxpayers are under constant audit as part of the IRS’s Coordinated Industry Case Program. While large companies or entities are the most likely candidates, the program may also require the audit of individuals. See ARTHUR H. BOELTER, 1 REPRESENTATION BEFORE THE APPEALS DIVISION OF THE IRS § 5:32 (2004).

100. The situation is certainly more difficult to monitor when individuals are involved. Despite long-standing rules prohibiting the use of material, non-public information in an investment context, lapses are not only uncommon but also frequently intentional, and at least in some instances, well-planned. See Matthew Rose & Kara Scannell, *Executives on Trial: Key Witness Mocked Stewart in His E-Mails*, WALL ST. J., Feb. 6, 2004, at C1 (indicating that Peter Bacanovic via Douglas Faneuil (his assistant) gave Martha Stewart material, non-public information which prompted her to sell her shares of ImClone stock).

notion supported by neither statute nor common law, and the Service provides no guidance as to what is meant by “sufficiently broad” with respect to separate account investment strategies. Just how narrow is too narrow? The Service clarifies that separate accounts must be adequately diversified within the meaning of section 817 and the relevant Treasury Regulations, but it is important not to forget exactly what that means.¹⁰¹ Under Treasury Regulations sections 1.817-5(b)(1)(i), a separate account may invest up to fifty-five percent of the total value of its assets in a *single* investment.¹⁰² Second, a separate account will be deemed adequately diversified even if four investments constitute ninety percent of the separate account’s total assets.¹⁰³ The clarity of these rules notwithstanding, the Service may challenge a separate account with minimal diversification as having an investment profile too narrow to pass muster. Moreover, the Service just recently pushed aside longstanding Treasury Regulations, effectively redefining publicly available¹⁰⁴ to include certain non-registered partnership interests, and the Treasury Department has proposed new regulations consistent with the IRS’s posture.¹⁰⁵ Thus, any well-announced safe harbors may not be all that safe. And why have gag orders, various paralyzing exhortations, “non-public availability,” and “non-direction of investments” gradually supplanted the triumvirate first articulated in Revenue Ruling 77-85 (i.e., investment control, voting control, and surrender rights). Revenue Ruling 2003-91 makes no mention of voting control or surrender rights. Is voting control no longer important, or have the doctrinal branches been bent to grow in a new direction? Does tax theory alone dictate true asset ownership, or do market innovations or prevailing political pressures somehow result in a redefinition of fundamental notions of established tax theory? In my view, fundamental tax notions survive market innovations and can be relied on to exact the proper treatment of those seeking to abuse variable contracts as investment vehicles. The current investor control doctrine, however, deviates from those well-established guidelines and appears to lack critical theoretical support.

101. Rev. Rul. 2003-91, 2003-2 C.B. 347.

102. Cf. Figure 9 (Appendix).

103. See *id.*

104. In Revenue Ruling 2003-92, 2003-33 I.R.B. 350, the Service took a position counter to then-governing Treasury Regulations. Under such regulations, it would appear that non-registered partnerships were not considered publicly available.

105. See Notice of Prop. Rulemaking, 2003-38 I.R.B. 595. The Treasury has proposed modification of its long-standing regulations. As modified, the Service’s redefinition of “public availability” would take effect.

While the Service appears to rely primarily on United States Supreme Court and Eighth Circuit precedent in Revenue Ruling 2003-91, a review of those authorities reveals that they offer very limited support to the Service's position. Indeed, if the ruling purports to set forth the investor control doctrine's theoretical foundation, it ultimately reveals the doctrine as an analytical edifice, constructed largely of Revenue Rulings that despite their general usefulness, do not constitute controlling, primary legal authority.

As a class, the United States Supreme Court cases relied on by the Service in Revenue Ruling 2003-91 are somewhat off point and appear to bear tangentially, at best, on the proper determination of basic asset ownership. For example, *Corliss v. Bowers*¹⁰⁶ concerned a taxpayer who created a trust, directing that the trust pay income to his wife for the duration of her lifetime.¹⁰⁷ Because the taxpayer retained the right to revoke the trust at any time, the Court concluded that he (and not his wife) should be taxed on trust income.¹⁰⁸ So, while the Court mentioned the impact of a taxpayer having command over property, such dicta cannot be elevated to the status of a holding, much less a "long standing doctrine of taxation."¹⁰⁹ In articulating its final conclusions in *Corliss*, the Court essentially restated the long-standing prohibition of anticipatory assignments of income.¹¹⁰ Likewise, the Service's reliance on other assignment of income cases, *Commissioner v. Sunnen*¹¹¹ and *Helvering v. Clifford*,¹¹² is misplaced. Indeed, it is in *Sunnen* that Justice Murphy emphasized in the first sentence of the Court's opinion that "[t]he problem of the federal income tax consequences of intra-family assignments of income is brought into focus *again*. . . ."¹¹³ The Court further noted that "[i]t is in the realm of *intra-family* assignments and transfers that [*Helvering v. Clifford* and similar authorities have] peculiar applicability."¹¹⁴

When a taxpayer purchases an annuity contract with the intent of using it as an investment vehicle, is the taxpayer attempting to assign income to the insurance company, or does the taxpayer have command over investment earnings in the same way that a parent controls income assigned to a child? Hardly. Such an approach is short-sighted. Classic

106. 281 U.S. 376 (1930).

107. *Id.* at 377.

108. *Id.* at 378.

109. Rev. Rul. 2003-91, 2003-2 C.B. 347 at 5.

110. *See* 281 U.S. 376.

111. 333 U.S. 591 (1948).

112. 309 U.S. 331 (1940).

113. *Sunnen*, 333 U.S. at 593 (emphasis added).

114. *Id.* at 605 (emphasis added).

income assignment antics seek to effect a *permanent* shift of income from one person to another to achieve a more desirable tax result. While an investment-focused annuity may offer a tax deferral, the whole point of such a product is to ensure that the contract purchaser can ultimately get the earnings out and into *his* pocket, an event that will invariably trigger taxation of the taxpayer.¹¹⁵ Even an attempt to apply assignment of income principles to tax deferral meets opposition:

The attitude of the law is that if a taxpayer is willing to accept delayed payment of his income he will be taxed accordingly. Tax policy thus provides no warrant for using the assignment of income doctrine to prevent tax savings through deferral. Not surprisingly then, courts have declined to invoke the assignment of income doctrine to prevent the deferral of income.¹¹⁶

Even in terms of the illegitimate use of a conduit to achieve a particular tax result, the Service cannot rely on cited precedent. In referring to *Frank Lyon Co. v. United States*,¹¹⁷ the Service, once again, highlights what appears to be convenient dicta without bringing forth the essence of the Court's final holding. Rather than accepting the Service's argument that the Frank Lyon Company had been used as a conduit, the Court held that "where . . . there is a genuine multiple-party transaction with economic substance . . . the Government should honor the allocation of rights and duties effectuated by the parties."¹¹⁸ In the end, the Court reaffirmed the notion that while some transactions may appear to treat one party as a conduit, the existence of true economic substance dictates that "conduit" notions be dismissed for tax purposes.¹¹⁹ Such reasoning is particularly appropriate in the investor control context, given that the Service has repeatedly contended in various Revenue Rulings that certain arrangements allow insurance companies to be used as investment conduits.¹²⁰

Although the investor control doctrine lacks the theoretical support of United States Supreme Court precedent, some degree of judicial affirmation arises in *Christoffersen*. In that case, the Eighth Circuit

115. Although many taxpayers could previously exclude a portion of all annuity payments from gross income, current law may subject 100% of an annuity contract payment to tax (after recovery of the entire investment in the contract).

116. Ronald A. Jensen, *Schneer v. Commissioner: Continuing Confusion over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 669 (1993) (citing *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971)).

117. 435 U.S. 561 (1978).

118. *Id.* at 583-84.

119. *See id.*

120. *See, e.g.*, Rev. Rul. 80-274, 1980-2 C.B. 27.

Court of Appeals concluded that taxpayers purchasing an annuity contract and specifically directing the investment of premiums to a particular mutual fund were to be taxed currently on contract earnings.¹²¹ While of substantive relevance, the decision suffers from many faults. From a judicial reasoning perspective, the primary weakness in the decision rendered in *Christoffersen* is its reliance on tangential precedent in the form of the assignment of income cases discussed earlier.¹²² What is more, the court in *Christoffersen* explicitly acknowledged that its holding derives from pre-TEFRA law.¹²³ Thus, the holding lacks force in the current legal context.¹²⁴ Put differently, the court's holding turns on the view that the taxpayers constructively received money. Per Treasury Regulations, constructive receipt arguments fail, however, if a taxpayer can establish that there are "substantial limitations or restrictions" with respect to access to the relevant funds.¹²⁵ Arguably, TEFRA destroyed any constructive receipt notions in the variable contract context by introducing substantial limitations or restrictions in the form of the income first rule and, more importantly, premature distribution penalties. The Service's own rulings indicate that the imposition of a penalty with respect to the surrender of an annuity contract voids notions of constructive receipt.¹²⁶ Is the TEFRA approach (with its focus on cash receipt) profoundly better from a theoretical perspective? Absolutely.

In taxing a company on the receipt of punitive damages in *Commissioner v. Glenshaw Glass Co.*,¹²⁷ the United States Supreme Court emphasized the following: "Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."¹²⁸ By changing the treatment of insurance company contract distributions in TEFRA, Congress appears to have embraced an "undeniable access" mindset. Rather than focusing on the apparent problem of contract holders exercising investment control, Congress imposed tax at the point at which it made the most sense—when the taxpayer first secured cash in hand. Such an approach

121. See *Christoffersen*, 749 F.2d at 513.

122. See *id.* at 515 (quoting *Corliss*, 281 U.S. at 378) (citing *Clifford*, 309 U.S. at 331).

123. See *id.* at 514 n.1.

124. While the court was obliged to apply the tax law as it existed in 1981, the absence of premature distribution penalties and the apparent ability of contract holders to access contract earnings *without* paying taxes would facilitate reaching the conclusion that taxpayers had easy and free access to the contract earnings.

125. Treas. Reg. § 1.451-2(a) (2005).

126. See, e.g., Rev. Rul. 68-482, 1968-2 C.B. 186.

127. 348 U.S. 426 (1955).

128. *Id.* at 431.

is also literally consistent with the Code's mandate that gross income include only that income which has been "derived."¹²⁹ An undeniable access approach also ensures horizontal equity.¹³⁰ Thus, those who invest in the markets either directly or indirectly through the *abuse* of insurance company contracts bear the same burden because contract holders receiving partial surrender proceeds will be taxed in the same manner as investors in mutual funds receiving fund earnings. Those contract holders opting to allow the cash value of their contract to build up will continue to enjoy a tax-free ride,¹³¹ and those who effect partial surrenders to effect an abusive purpose are forced to pay both taxes and penalties.¹³²

The Service's pre-TEFRA Revenue Rulings (and *Christoffersen*) focus erroneously on forced notions of asset ownership. Instead, the focus should have been on cash-yielding realization events. Consider the average shareholder. Stockholders of a company may possess shares that have appreciated in value. Typically, the investor has the option of selling some or all of his shares in much the same way that a contract holder may effect a partial or complete surrender. The shareholder maintains absolute investment control and may avoid taxation by continuing to hold the investment. Under the Service's pre-TEFRA rulings, a contract holder was taxed, despite the continued holding of the investment (and without the receipt of funds), largely because the contract holder held partial surrender rights and exercised some degree of investment control. TEFRA has closed the pre-existing tax loophole. Code provisions introduced in TEFRA punish (by penalty and income-first taxation) those determined to use variable contracts as investment vehicles, and it may well be the case that the strongest deterrent for potential future abuse would be the specter of stiffer penalties.

B. Investor Control Evolution in the Abstract

Even though the investor control doctrine lacks the support of common law and fails to embrace an undeniable access rationale, it is still

129. See I.R.C. § 61(a) (2004). By definition, "to derive" is to get or receive (something) from a source; etymologically, "derive" is a combination of (*de*), which means "from," and (*rivus*), which means "stream." See WEBSTER'S NEW WORLD COLLEGE DICTIONARY 389 (4th ed. 2000).

130. "The principle of horizontal equity is that people similarly situated should be taxed alike, which is translated under an income tax into the principle that people with the same income (properly defined) should pay the same tax." KLEIN, BANKMAN, BITTKER & STONE, FEDERAL INCOME TAXATION 19 (8th ed. 1990).

131. See I.R.C. § 72(e)(1)(A)(I) (2004) (indicating that the provision applies to amounts received).

132. See *id.* § 72(e), (q).

important to assess its validity (as currently evolved) in the abstract. Fundamentally, it would appear that the doctrine aims to ensure the Service's context-specific notion of horizontal equity (i.e., investors exercising *the same level of investment control* should bear the same tax burden with respect to contract earnings). It would further appear that Revenue Ruling 2003-91 actually makes it substantially more difficult to achieve *that* version of horizontal equity because the ruling authorizes a much higher level of individual investor investment discretion than previously articulated and *within* the variable contract vehicle at that. Thus, rather than allowing allocation of premiums to "stock" per Revenue Ruling 82-54, a variable contract holder now may specify "only South American stock" per Revenue Ruling 2003-91. Rather than suffering the immediate tax consequences that would attend a direct, broker-assisted investment—for example, in a mix of money market, emerging markets, South American stocks, and Asian markets funds—an investor can now make substantially the same, or very similar, investments via a variable contract and enjoy the benefit of tax-free build-up. Such a reality would appear to *enhance* the likelihood that an insurance company could be used as an investment conduit and, in many ways, allows a contract holder to approach the same position as a non-contract holder. Under the "undeniable access" version of horizontal equity (i.e., taxpayers enjoying the same cash-based taxable income position should bear the same tax burden), the tax and penalty rules ultimately prevent the contract holder from occupying the same economic position as the non-contract holder with an identical investment profile, despite the fact that the two bear an unmistakable fraternal likeness. It is true that the current investor control doctrine imposes a gag order on investment-related communications to prevent even the appearance of investor control, but as noted earlier, administrability problems arise in many contexts.

Consider also the harm done to Congress's work in DEFRA. While one can question the wisdom of Congress's rapt focus on the public availability of separate account investments (given that the markets are eventually tapped for ultimate investment regardless of how many transparent entity layers must be penetrated), Revenue Ruling 2003-91 practically blesses the notion that an insurance company can offer a series of funds that are basically clones of existing publicly available funds.¹³³ Indeed, given that a separate account is adequately diversi-

133. The legislative history of DEFRA effectively authorizes non-public funds that are similar to public funds. See H.R. REP. NO. 98-861, at 1055 (1984) (Conf. Rep.), *reprinted in* 1984 U.S.C.A.N 1445, 1743. The Service did not, however, see the need to openly embrace this reality by pronouncement.

fied even if fifty-five percent of its total assets are invested in a *single* investment,¹³⁴ an investor could effectively wield considerable investment control via a variable contract over a wide range of investment choices (e.g., where a company offers twenty sub-accounts, each of which has unique investment goals and has ninety percent of its total assets invested in no more than four companies). Is the underlying regulatory theme that an individual should be able to direct their investments freely? To be sure, the Service would steadfastly disagree, but it remains true that as a matter of theory, Revenue Ruling 2003-91 gives Revenue Ruling 82-55 a rather steroidal boost by safe-harboring up to twenty specific sub-account options. Why now? At least one rational argument is that the prevailing political environment and the drive to effect the privatization of Social Security has forced a pre-emptive doctrinal retreat away from control-based notions of horizontal equity and closer to cash-receipt based, undeniable access notions of horizontal equity. And as train wrecks go, the clash between traditional notions of investor control and the investor discretion contemplated in various Social Security privatization models was quite imminent.

C. *Social Security Privatization v. Old School Investor Control*

Today, Social Security is a pay-as-you-go system whereby taxes from current workers are collected and immediately transferred to benefit recipients (without the accumulation of interest).¹³⁵ The pay-as-you-go system is inherently unstable because it depends on “the business cycle, fertility rates, inflation, and demographics. Each generation must finance its parents’ retirement on the faith that its children, in turn, will have the benevolence and capacity to fulfill their social obligation.”¹³⁶ As current baby-boomers approach retirement in an age where life expectancy has increased, the prognosis for Social Security’s solvency has grown more grim.¹³⁷ “Social Security trust funds will be rapidly depleted[,] and annual revenues from Social Security taxes will be unable to cover annual expenditures.”¹³⁸ Commentators generally conclude that prompt Social Security reform is necessary:

In the current context, dramatic reforms are needed. Social Security must be liberated from its inherently contradictory welfare and

134. See Treas. Reg. § 1.817-5(b)(1)(i) (2003).

135. See Lewis D. Solomon & Geoffrey A. Barrow, *Privatization of Social Security: A Legal and Policy Analysis*, 5 KAN. J.L. & PUB. POL’Y 9 (1995).

136. *Id.* at 14.

137. See June E. O’Neill, *Why Social Security Needs Fundamental Reform*, 65 OHIO ST. L.J. 79 (2004).

138. See Solomon & Barrow, *supra* note 135, at 9.

insurance roles and its fundamentally unstable financing scheme. The current system must be replaced with a program that grants workers a stake in their retirement, eliminates the negative impact on personal savings, and allows retirees to enjoy the benefits they have earned. Privatization is necessary to achieve these goals, to break the political quagmire, and to provide for the future of tomorrow's retirees. Privatized pensions offer superior returns, carry protected property rights, and are beyond the reach of politicians.¹³⁹

While there are various privatization models to consider,¹⁴⁰ the prevailing general notion is the following:

The central idea is to take a portion of the tax every worker pays into the Social Security system and put it into a savings account *that each individual can decide how to invest*. By turning every American into an investor, and a government safety net into a system that rewards judicious risk and individual initiative, Republicans believe they can change how Americans see every question from free trade to capital gains-tax cuts.¹⁴¹

Bearing the foregoing investor control discussion in mind, it should be readily apparent that absent overt Congressional efforts to protect taxpayers, the level of investor discretion and control contemplated in a post-privatization epoch would have resulted (under pre-2003 IRS doctrine) in the immediate taxation of taxpayers with respect to their Social Security accounts.¹⁴² The more rational alternative is for the investor control doctrine to open wide and swallow privatization—for its proponents to somehow redefine or reshape the doctrine to make privatization theoretically palatable.

Under various IRS rulings, those directing the investment of assets are deemed to possess sufficient incidents of ownership so as to be considered the owners of the relevant assets and are thus deemed liable currently for taxes on asset earnings. Revenue Ruling 2003-91 can be viewed, arguably, as a necessary splitting of the doctrinal baby. The ruling substantially liberalizes the ability of insurance companies to offer various investment-specific sub-accounts and indirectly enhances the ability of contract purchasers to direct the investment of their premiums. As such, the ruling can be viewed as a pre-emptive accommodation of the level of investor discretion contemplated by Social Security privatization.

139. O'Neill, *supra* note 137, at 79.

140. See Solomon & Barrow, *supra* note 135 (discussing both partial and full privatization models).

141. Karen Tumulty & Eric Roston, *Is There Really a Crisis?*, TIME, Jan. 24, 2005, at 22, 24 (emphasis added).

142. See, e.g., Rev. Rul. 77-85, 1977-1 C.B. 12.

At the same time, Revenue Ruling 2003-91 attempts to erect high, soaring Chinese walls between contract holders and contract issuers or advisors. Such rules can be viewed as having primary applicability outside the privatization context where menu offerings have suddenly and inexplicably been enriched, courtesy of the IRS. Could Revenue Ruling 2003-91 be viewed as simply providing necessary, updated guidance? Possibly, but such guidance has been needed for over twenty years. Further, since the issuance of Revenue Ruling 81-225 (the Service's major investor control ruling before Revenue Ruling 2003-91), the Service has been in no rush to guide taxpayers. In particular, the Service issued various private letter rulings after 1981 in which investor control or asset ownership issues may have been present, but the Service routinely declined to comment on such issues.¹⁴³ More importantly, to the extent the Service wishes to provide guidance, it need not do so in a manner that enhances the perception that an insurance company can be used as an investment conduit, especially by those with modest liquidity needs and strong interests in sheltering investment income.

It should, of course, be noted that as of this writing, we do not have a clear, legislative privatization proposal, so any pre-emptive accommodation is, arguably, premature. Further, even if Revenue Ruling 2003-91 serves as a pre-emptive accommodation, the ruling clearly does not contemplate any investor discretion with respect to the choice of *individual* sub-account investments in the market. At the same time, however, the privatization concept is not new, and the basic contours of the likely form that privatization will take are readily discernable. Privatization certainly contemplates a healthy degree of investor decision-making¹⁴⁴ and will likely allow choice from a very broad, but clearly restricted menu of diversified, fund-like investments, each with a unique investment objective. The content of that menu, of course, will likely be governed by federal guidelines, and the private citizen may be allowed to offer input, but will not likely have a hand in the final fund-selection process. Barring the notion of investor input, Revenue Ruling 2003-91 could easily be viewed as an anticipatory model with the clear promise of favorable tax consequences.

143. See, e.g., I.R.S. Priv. Ltr. Rul. 94-37-026 (Sept. 16, 1994); I.R.S. Priv. Ltr. Rul. 97-48-035 (Nov. 28, 1997); I.R.S. Priv. Ltr. Rul. 200010020 (Mar. 10, 2000); I.R.S. Priv. Ltr. Rul. 200016008 (Apr. 21, 2000); I.R.S. Priv. Ltr. Rul. 200108038 (Feb. 23, 2001). *But see* I.R.S. Priv. Ltr. Rul. 200248021 (Nov. 29, 2002) (concluding that the insurance company, and not the contract holder, was the owner of certain assets for federal income tax purposes). A Private Letter Ruling ("P.L.R.") is a ruling issued by the IRS to a specific taxpayer to clarify how the Service will treat a particular transaction. No other taxpayer may rely on the ruling or cite it as precedent. *Id.*

144. See Tumulty & Roston, *supra* note 141.

One legitimate question to be asked is whether tax doctrine in this area has ever before accommodated apparently forthcoming federal legislation. Though it is impossible to answer that question with absolute certainty, the Service's major pre-TEFRA ruling in this area, Revenue Ruling 81-225, was issued in 1981, one year before the enactment of TEFRA. As noted earlier, TEFRA responded to the problem of "wraparound annuities" and premature, tax-free access to contract earnings by imposing the income first rule and premature withdrawal penalties in the variable contract context. Revenue Ruling 81-225 addressed a number of fact scenarios, but in that ruling, the Service ultimately concluded that desirable tax results would attach *only* to those purchasing *variable* contracts and allocating premiums to funds that were not publicly available.¹⁴⁵ And it is only the variable contract route, per the final provisions of TEFRA, whereby a taxpayer would subject himself to the income first rule and potential premature withdrawal penalties. While correlation and causation are not one and the same, the potential parallel between Revenue Ruling 81-225 and TEFRA, and Revenue Ruling 2003-91 and potential Social Security privatization legislation is unmistakable. Revenue Ruling 2003-91 provides two assurances. First, opponents of privatization cannot argue that negative tax consequences will attend a private citizen's exercise of discretion with respect to a wide range of broad investment strategies (of the government's sole choosing) made available to him. Second, the investor control doctrine will never be the same, high Chinese walls notwithstanding. Had the Service embraced an undeniable access rationale (as did Congress under TEFRA) and steered clear of its significant incidents of ownership notions, investor control might have been spared its latter-day theoretical deconstruction in Revenue Ruling 2003-91.

What follows in the next part of this Article is a variable contract investment model. With undeniable access as its guiding precept for the imposition of tax and existing law as an effective policing mechanism, the model demonstrates that one can achieve horizontal equity between those allocating investments under variable life and annuity contracts, those potentially directing investments in Social Security accounts, and those directing investments in a traditional brokerage account. Due regard for the need to protect retirement savings and ensure vertical

145. Rev. Rul. 81-225, 1981-2 C.B. 12.

equity¹⁴⁶ necessitates the incorporation of age-sensitive safeguards and variable contract investment limits.

IV. VARIABLE CONTRACT INVESTMENT MODEL

Even in its highly evolved state, the investor control doctrine presents a number of difficulties for those seeking to provide for their retirement by investing in a variable contract. Investors may certainly enjoy the new range of sub-account options, but at the same time, they must contend with the fact that investment-related communications (in various contexts) are banned. Issuing companies, likewise, may proceed comfortably, to some degree, in the sense that they may offer a wide range of unique sub-accounts, but must ensure that all investment options remain sufficiently broad. With a complex web of rules, warnings, and prohibitions, even a facts-and-circumstances analysis promises little.

I propose a variable contract model in which investor control is dismissed as a doctrine. To ensure that variable contracts are not abused as they have been in the past, I urge the consideration of higher premature withdrawal penalties, such as fifteen to twenty percent,¹⁴⁷ and per the income first rule, the prompt imposition of tax upon the immediate receipt of cash or the use of the instrument to secure the same effect (e.g., using the contract as collateral to secure a loan). Rather than prohibiting investor discretion, I propose that investors be allowed to choose specific assets to invest in (with investment professional oversight to ensure adequate risk diversification). The model also contemplates a self-designed sub-account to complement sub-accounts designed and managed by the investment manager. To ensure that retirement savings are augmented, however, the percentage of assets subject to investor control (with oversight) should be age-sensitive, such that as one approaches retirement age, the percentage of assets subject to direct investor investment control grows progressively smaller. The following table is a preliminary structural sketch:

146.

Vertical equity refers to the relative amounts of taxes paid by people with different incomes. The rate structure of our income tax reflects adoption of a principle of vertical equity called *progressivity*, which means that as one's income rises the *proportion* of income that one pays as a tax rises. * * * [P]rogressivity is designed to reduce the inequalities of income associated with our largely free-market system.

KLEIN, *supra* note 130, at 20.

147. The current premature withdrawal penalty is ten percent. See I.R.C. § 72(q)(1) (2004).

<u>Early Pre-Retirement Phase</u>	<u>Late Pre-Retirement & Retirement Phase</u>
Age 25-30: 50% Investor Discretion	Age 46-50: 25% Investor Discretion
Age 31-40: 75% Investor Discretion	Age 51-60: 10% Investor Discretion
Age 41-45: 50% Investor Discretion	Age 60-65: 5% Investor Discretion
	Over Age 65: No Investor Discretion

As noted earlier, assets outside the self-designed sub-account would be managed by an investment professional, and individuals would have the ability to allocate and reallocate investment dollars among broad investment strategies of the general type as those presented in Revenue Ruling 2003-91; the relevant investment strategies would be chosen solely by the investment advisor for the various sub-accounts, although investors would have the annual opportunity to petition for the inclusion of various investment objectives. As under the current statutory regime, tax-favored access to contract earnings (without the imposition of penalties) would require that a stated exception apply.¹⁴⁸ Under this model, such exceptions would be modified to include major medical emergencies, critical illnesses of the taxpayer or his dependents, and catastrophic personal property losses (e.g., loss of principal residence¹⁴⁹ due to fires, floods, hurricanes). Further, this model would require the modification of adequate separate account diversification standards to force a closer alignment with realistic market notions of adequate portfolio diversification. Finally, aggregate lifetime investment in variable contracts would be capped at \$1 million to ensure vertical taxpayer equity.

From a tax theory perspective, I argue that this model is in full accord with long-standing tax doctrine because, per TEFRA, it requires the imposition of tax (and potential penalties) only on the receipt of money (i.e., only on partial or complete surrender of the contract). Unlike the traditional investor control model, the proposed undeniable access model does not view taxpayer direction of investments as a sufficient trigger for the imposition of tax because direction of contract-related investments is not considered a direct taxpayer-level realization event. Under the model, designing a separate account and directing that specific assets be purchased and held by the separate account is not realization *ab initio*. The separate account holds the relevant assets in much the same way a shareholder would buy shares and hold them. Although asset reallocation would require the sale of assets (followed by reinvestment of the proceeds or the holding of proceeds for future investment), one can

148. See generally *id.* § 72(q)(2).

149. The definition of "principal residence" in this context would be restricted to the home in which one lives on a day-to-day basis.

still argue that no direct, taxpayer-level realization event has occurred because the investor still holds the contract and does not have undeniable access to any contract earnings or gains until the contract has been partially or completely surrendered. This notion is supported by various Revenue Rulings. The Service has previously stated that investors may allocate and reallocate variable contract investments without tax incident.¹⁵⁰ Yet, asset reallocation by a variable contract holder indirectly requires a realization event at the sub-account level—assets held in one sub-account must be sold and reinvested via another sub-account in different assets. So, even though the contract holder's action triggers a realization event, the Service implicitly acknowledges that the contract holder and a private citizen causing the same market event are not similarly situated. In many ways, the contract holder's position differs substantially from that of a person holding a brokerage account or writing a check at a financial institution to access funds. The person with a brokerage account must pay commissions, fees, and income taxes on realized gains, but he does not face aggressive tax penalties solely because he decides to liquidate and take possession of his holdings. Also, those writing a check to withdraw cash and earned interest surely face no Code-imposed penalties as a result of the withdrawal. Variable contract holders face the specter of the income first rule and the imposition of penalties should they withdraw contract earnings prematurely.

Should it matter from a tax theory perspective whether an individual triggers a realization event directly or indirectly? In the abstract, the answer is no, but if the realization event results in the receipt of cash earnings or gains, then (barring the application of a special rule) recognition seems altogether appropriate. Shareholders have a bevy of rights (apparently more than variable contract investors). Ordinarily, they have voting rights, liquidation rights, and dividend rights, yet they are not taxed solely because they have the power to control the investment of their money. Nor, for that matter, are they taxed on mere appreciation in the value of their shares. Rather, shareholders pay taxes only when gains are realized *and* when such gains are readily available as cash. Appreciated assets in corporate solution are not subject to tax at the corporate level. It is only when those appreciated assets are distributed that taxation of the corporate enterprise is appropriate.¹⁵¹ Likewise, in a post-TEFRA world, it makes little sense to continue imposing tax as a result of vague and shifting notions of investor control. Application of an undeniable access rationale in the imposition of taxes

150. See Rev. Rul. 2003-91, 2003-2 C.B. 347.

151. See I.R.C. §§ 311(b), 336(a) (2004).

in the variable contract context will present no conflict with the investor discretion contemplated in the Social Security privatization arena.

V. CONCLUSION

As a doctrine, investor control lacks firm theoretical footing. While market developments and taxpayer abuse of prevailing tax rules made change necessary, Congress effectively solved the problem by enacting TEFRA, which imposed taxes (and penalties) on premature access to variable contract earnings without resort to investor control concepts. In essence, Congress embraced and applied an undeniable access rationale, an approach fully consistent with tax theory fundamentals. The construction and deconstruction of an investor control doctrinal complex in a manner that appears to correspond conveniently with significant tax legislation has the undesirable effect of making fundamental tax theory appear to be the pawn of prevailing political sentiment. In much the same way Revenue Ruling 81-225 achieved a desirable tax result consistent with subsequent TEFRA rules governing access to variable contract earnings, Revenue Ruling 2003-91 appears to be a pre-emptive theoretical accommodation of Social Security privatization and the individual investor discretion privatization contemplates. Otherwise, the pronouncement represents a sudden, inexplicable liberalization of well-established rules.

An undeniable access rationale makes the most sense in terms of taxing variable contract earnings, especially when current Code-based rules tax and penalize abusive contract use, protect traditional use, and minimize the likelihood of rule circumvention. The investor control doctrine—with its obsessive focus on public availability and its recent introduction of gag orders—is long beyond its heyday. TEFRA-based rules have effectively reduced “improper variable contract use” to a tax and penalty. Those rules should serve as effective deterrents to those who would abuse variable contracts. The investor control doctrine should not, however, continue to impede investor-guided growth in retirement savings.

